

**INTERGOVERNMENTAL COOPERATION IN THE ENFORCEMENT OF
THE SECURITIES LAWS**

An Address by

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Three and one-half years ago I accepted an appointment to the Commission's staff and left the State of Connecticut where I had been engaged in the private practice of law. Now while it is true that I had heard of your President Mel Hall, certainly at that time I had not had the pleasure of meeting him nor had any of my then clients been subjected to his watchful eye. Over these several years at the SEC I have come to know him and have worked with him. While I think that I can not disregard that natural comity that blossoms from that which is common to us both -- the nutmeg -- I am equally certain that without it we would have enjoyed the very real feeling of cooperation, although at different levels of governmental responsibility, while frequently in the same geographical sphere. And so, Mel, since you have asked me to speak, I have selected as the theme of my remarks the importance of effective cooperation among governmental agencies in the enforcement of securities laws.^{1/}

We are now in the midst of a national debate on the question of the relative powers of the federal and state governments. Indeed, there has always been a great deal of talk about the encroachments of the federal government in matters which have been considered to be peculiarly within the jurisdiction of the state. I am sure it must be a tremendous satisfaction to all of you, as it is to me, to know

^{1/} The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

that we are working jointly in an area in which that conflict is not present. In view of the wide national importance of preserving the integrity of our security markets, because our national prosperity depends on the growth and honesty of those markets, it is most essential that every agency of the state and federal government should cooperate to the fullest extent in helping to provide a free flow of capital to our national economy and at the same time to prevent the diversion of such capital into dishonest hands. From the very inception of federal legislation in the field of securities, the federal statutes have specifically provided that such legislation was in no way intended to interfere with the continued functioning in the field by the several states.^{2/} Indeed, one of the purposes of the Public Utility Holding Company Act of 1935, for instance, was to free the operating utility companies from absentee control which had prevented state authorities from exercising effective regulatory authority over them. This principle has not only been enunciated in the statutes but has flowered to the fullest extent in the actual administration of our laws. The cooperation between federal and state officials in this field can well be regarded as an outstanding example of the way government should work.

The need for such cooperation in the securities area is particularly essential because of the limitations to which each of us is

^{2/} See Securities Act of 1933, Section 18; Securities Exchange Act of 1934, Sections 2, 28(a); Public Utility Holding Company Act of 1935, Sections 1, 18(b), 19; Trust Indenture Act of 1939, Sections 302, 326(2); Investment Company Act of 1940, Sections 1, 50, 40(c).

subject. Perhaps your greatest obstacle to effective securities regulation is your state boundary. Indeed, that obstacle was one of the primary reasons for the enactment of federal legislation. It is virtually impossible for a state to protect its citizens from selling campaigns conducted from a neighboring state by mail and long-distance telephone. Even extradition is no solution. If a criminal violates your laws from a distance and remains out of the state, he is technically not a fugitive and without federal regulation could carry on his swindle with impunity. As a matter of fact, we are now faced with a new problem somewhat akin to that situation. In order to avoid the disclosure requirements of federal law, persons in control of an issuer have transferred large blocks of its securities through foreign banks and trusts to brokers and dealers for resale to the public in boiler rooms, a situation I will discuss a bit later. The secrecy surrounding accounts in these institutions shield the identities of the controlling persons and make it more difficult for us to detect those responsible for violations of the law.

We also have our limitations. An important one is that of federal jurisdiction. We must not forget that the federal government is not a sovereign in the sense that each one of your states is a sovereign. The United States is a government of limited powers and must find its source of authority in the Federal Constitution. All of the federal securities laws, therefore, are based on the Congressional jurisdiction over the mails and the facilities of interstate commerce.

Accordingly, before considering any action under our statutes, it is first necessary to find some use of the mails or of the means or instrumentalities of interstate commerce. This is so whether the action is civil or criminal, whether it is public or private. Of course, the jurisdictional factors need not be present in every step in a scheme if they are present somewhere along the line.^{3/} Some criminals have endeavored to take advantage of these requirements to evade the sanctions of the federal statutes, but they have generally not been successful. A swindler may studiously avoid mailing letters only to find that he has overlooked a certain automobile trip to a nearby town in a neighboring state. Or he may carefully stay away from the mail box and the telephone, remain within the confines of a state, and then learn to his dismay that the bank in which he deposited the victim's check had mailed the check to the victim's bank for collection. Nevertheless, situations do arise in which we are unable to obtain evidence of the use of the mails or of interstate facilities. In that event, as in other cases, we must look to your facilities to combat securities frauds.

I think I should say a word about the intrastate exemption from registration under the federal Securities Act of 1933.^{4/} This exemption

^{3/} Some provisions (e.g. Sections 7(c), 8, 9(c), and 14(b) of the Securities Exchange Act of 1934) are not themselves dependent on the use of the mails or facilities of interstate commerce, but they came into play by virtue of the status of the person regulated, e.g. a member of a securities exchange the regulation of which rests on such jurisdictional factors.

^{4/} Section 3(a)(11), 15 U.S.C. 77c(a)(11).

is predicated on the Congressional concept that in matters of a purely local nature, there is no need for the disclosure provisions of the federal Securities Act. Accordingly, exempted from registration but not from the anti-fraud provisions of the Act is any security which is part of an issue of a local corporation sold only to persons resident in that state where the issuer is incorporated in that state. I am certain that you are all called upon at one time or another to consider offerings of securities in situations where the issuer is relying upon this intrastate exemption. I think you can perform a valuable service not only to us but also to your own citizens if you make it a point to remind such issuers who wish to rely upon this exemption that there are certain risks involved. It should be noted that the exemption is available only if all of the issue is sold to residents of the state. If any part is sold to a non-resident, directly or indirectly, the entire exemption is lost and all of the sales, even those to residents, become unlawful. Likewise if within a short period one or more of the purchasers should resell to a non-resident, the purchaser might be considered an underwriter within the definition of the Act and the exemption will be destroyed. This could be of serious import to the issuer and to those who participate in the offering. Even if the sale to the non-resident is inadvertent and even if it should not warrant criminal action, nevertheless should the stock decline in value, all who participated in the sale would be subject to civil liability at

the suit of all of the investors. Moreover, if the issuer finds that it cannot raise the desired amount from residents of the state, it cannot change horses in midstream and shift to Regulation A or some other exemption, for the intrastate exemption will then be lost as to the part of the issue earlier sold in reliance upon it.

You are all familiar, of course, with the cooperation that exists between our Commission and the Department of Justice in connection with criminal prosecutions, as well as with the cooperation of the Post Office Department in cases involving mail fraud. But I think you would be amazed at the extent of the unselfish and ready cooperation that exists between our Commission and many other branches of the state and federal governments. I think you might be interested in hearing a few examples which come to mind at random.

Only recently the testimony of a California state official was needed in connection with one of our cases in New York City. Time was short, and the situation was complicated by a state law which forbids a state official to absent himself from the state without the consent of the Governor. Our regional administrator telephoned the Commissioner of Corporations in that state and within twenty-four hours the official had received the authority to proceed to New York.

In view of the varied nature of the enterprises which attempt to raise capital, the Commission must necessarily call upon other agencies for every sort of scientific, engineering, statistical and

economic information. If this were not possible, the staff of experts which the Commission would have to maintain to cover all of the technical fields would be exorbitantly expensive. It has given us the utmost satisfaction to discover the willingness with which every type of agency of the state and federal governments has responded to our requests. Indeed, with lesser frequency, we have even requested and obtained the same type of cooperation from private organizations, such as Better Business Bureaus, universities, etc. In one hearing, we had expert witnesses in the fields of photography, optics and economics, which were furnished to us by the Army Signal Corps, the Department of Commerce, the National Bureau of Standards and Johns Hopkins University. In another proceeding, we were furnished the expert testimony of a soil chemist from the Department of Agriculture. In connection with mining enterprises, we have had the cooperation of the Atomic Energy Commission, the Bureau of Mines, the United States Geological Survey and the Defense Minerals Exploration Administration. In the petroleum field, we receive reports regularly from several states showing the allowable production permitted under the proration laws, as well as data concerning the completion of wells.

Frequently, the provisions of state law are helpful in obtaining enforcement of both the state and federal laws. For instance, in Michigan there is a requirement for an opinion by the issuer's counsel regarding the availability of an exemption from registration under the federal Securities Act. Lawyers who are called upon to prepare such

an opinion frequently check with our Detroit office and are surprised to learn that they do not have the exemption they thought they had, and steps are then taken to make the proper filings that are required by both the state and federal laws.

State authorities at times, when it was needed, have provided us with auto transportation, photocopying equipment, tape recording facilities, etc. In one situation, the Oil Conservation Commission of the state reproduced and certified for us more than fifty documents in a few hours.

We have received assistance from Railroad Commissions, Insurance Commissioners, State Liquidators, state and federal tax officials, etc. We have had fugitives and witnesses located for us by immigration authorities, F.B.I agents, and Chiefs of Police.

One of the state securities commissioners has been alert to call to our attention the activities of registered broker-dealers who he suspected might well bear watching. Frequently his suspicions turned out to be well-founded. Certainly, this is a situation in which a state commissioner has well performed his duty of protecting the investing public even though the particular violations that were discovered may not all have been technically violations of state law.

Of course, this cooperation is far from being a "one-way street." We wish to be just as helpful to you as you are to us. In a recent case in which we had a pending investigation, we learned that the local state authorities had a similar investigation which was nearer completion than our own, whereupon we made our files available to them and our investigators testified before the state Grand Jury. The case resulted in a plea of guilty.

Frequently, our personnel are called upon for assistance in strengthening the state enforcement laws. One of our regional administrators, for example, was invited to participate in drafting amendments to a state securities law to plug up loopholes in the statute and later presented the proposed amendments to the appropriate committees of the House and Senate of that state. Those amendments were adopted and have greatly strengthened the enforcement of the securities law in that jurisdiction. Our regional offices, which are situated near the borders, have cooperated in the same manner with the authorities in Canada and Mexico.

I am sure you are all aware of the securities violations files which we maintain in Washington and of the bulletins which we issue quarterly. These bulletins contain current reports of securities violations including criminal, injunctive and administrative actions by both the federal and state authorities. It also includes a cumulative list of persons who are reported to be wanted by state, federal or provincial authorities on criminal charges which involve securities

violations. The bulletin, of course, is for the confidential use of cooperating enforcement agencies and is not for public use or distribution. It may interest you to know that our securities violations files cover more than 62,000 names of persons who have been reported as being involved in securities violations. Those of you who have not taken full advantage of this source of material are earnestly invited to do so. Your inquiries will receive prompt attention. I would like to impress upon you the fact that the effectiveness and completeness of this bulletin is dependent almost entirely on your cooperation. We can only include the information and the reports which you send to us. I might remind you that this so-called "clearing house" for information relating to securities violators was established in 1935, primarily at your request and for your assistance in securities law enforcement, and I urge you to do your utmost to make it effective.

You might be interested, incidentally, in a pamphlet which the SEC prepared for the Federal Small Business Administration as an aid to small business concerns desiring to raise small amounts of capital from the public. This pamphlet is entitled "How the Securities Act of 1933 Affects Small Business" and may be obtained from the Small Business Administration, Washington 25, D. C.

Of course, as we are all aware, the securities laws of the several states vary considerably not only with respect to language but, even more important, as to the methods used to protect the public

from securities frauds. It follows, therefore, that not all of the methods used for cooperation between federal and state officials are applicable in all situations. But, where some of these procedures can be utilized, they have proven very effective. For example, one of the states furnishes to our regional office information with regard to all applications for state permits under the securities law. This enables our regional office to check with the prospective offeror prior to the date of the offering to determine what consideration has been given to compliance with the federal statutes. This arrangement in many situations has prevented inadvertent violations of the federal laws. Moreover, the regional administrator is then in a position to furnish to the state authorities pertinent information with reference to the offering and the persons involved, which enables the state authorities to better evaluate the offering with regard to their own statute.

An interesting example of the way mutual cooperation can work occurred in one of our western states, where the state authorities turned over to us evidence of violations by a person in a neighboring state who was out of the reach of their jurisdiction. We conducted a further investigation of the case and concluded that this was a problem peculiarly susceptible to prosecution by the neighboring state and we, in turn, then gave them all of the information and they prosecuted the matter to its conclusion.

There are many situations, of course, where we exchange with state authorities the information in our files and we both make use of our enforcement powers. Frequently in the same case injunctions or comparable orders are obtained in both state and federal courts. I have never felt that this represents any unnecessary duplication of effort. I believe that each action serves a separate and desirable purpose since each has different legal effects.

As you are aware, we at the SEC have felt so strongly about the value of the cooperation between our respective agencies that we have welcomed the suggestion that, in addition to sporadic contacts between our various regional offices and the several state authorities, there should be a formal liaison committee between us and your Association. This committee now meets twice a year, and has already shown how valuable its conferences can be. At last year's conference, there was a discussion concerning the desirability of closer cooperation in connection with our Regulation A offerings. Just about a year ago, we wrote to the chairman of your liaison committee and set forth our suggestion for a cooperative program. Among the suggestions was one for the transmittal to us of the supporting evidence underlying state cease and desist orders. Such evidence was forthcoming from many states, as a result of which a number of suspension orders have been issued by our Commission.

You know, of course, of the weekly report which is issued by the Commission and sent to each state, listing information concerning each new Regulation A filing, including the jurisdiction in which the offering is to be made and any suspension order action that is taken.

Some of you have told us that this report has been of great assistance to you.

Only a few weeks ago the Commission adopted a new policy memorandum addressed to all of its regional administrators regarding cooperation with federal, state and Canadian enforcement agencies. This memorandum is necessarily of an intramural nature. Generally speaking, however, it is intended to facilitate cooperation with other enforcement agencies and to relieve regional offices from the necessity of obtaining prior clearance from the Commission in situations where the supplying of information or the referral of cases to other enforcement agencies is in the public interest. This action by the Commission is a recognition of the Commission's appreciation of the valuable service that state and Canadian enforcement authorities render in protecting the public in securities matters. It enlarges considerably the discretion afforded to our regional offices to make available to state agencies material which may assist them in the enforcement of state laws. This discretion has been extended not only with regard to state agencies but also to those in Canada.

While effective cooperation among Securities Administrators within a nation is most desirable and essential, cooperation across international boundaries is just as much so since only by such cooperation can frequent frustration of the objectives of all of us be avoided. Where securities flow freely back and forth across an international boundary, as is the case with the United States and

Canada, we may congratulate ourselves upon this further evidence of the close ties linking our countries. At the same time we must recognize that, without effective cooperation, such transactions may be carried on in violation of the laws of both countries since neither has control of both ends of the transaction.

For this reason I am happy to report that the cooperative endeavors of the Securities Administrators of the Canadian provinces and the SEC have proceeded with increasing smoothness and effectiveness since our last meeting in Maine. The Ontario and Quebec Commissions have continued to give us outstanding cooperation in important cases, involving both offerings from Canada and situations where United States citizens engaged in schemes to evade our laws have "washed" their transactions through Canada in an effort to throw us off the track. The Gregory case in which we worked closely with the Quebec Commission in the collection of evidence on both sides of the border and in resulting administrative and legal proceedings is an outstanding example of international cooperation. We have also worked closely with administrators in Western Canada in connection with a number of cases where we have consulted together and proceeded with collection of evidence and with proceedings, administrative, civil, and criminal on both sides of the border. By periodic visits we have come to know each other better and by review of our respective statutes we have arrived at a better understanding both of the scope and the limitations of our respective jurisdictions. Only last year we revised our Regulation A to require

Canadian promotional issuers to qualify under the Provincial securities laws. This should assist those provinces in the enforcement of their laws.

There are, of course, differences in regulatory philosophy between ourselves and the various Canadian provinces, just as there are differences among the various states. I think, however, that we have arrived at a mutual understanding that none of us are prepared to tolerate fraud, and that cooperative means are both available and necessary if fraud is to be detected and punished. Beyond that, I suggest that we develop an increasing understanding and respect for differences of viewpoint concerning the desirable scope and nature of securities regulation. At the same time I venture to suggest that a person who is willing deliberately and intentionally to violate the laws of a friendly foreign country manifests thereby a disrespect for law which all of us, as law enforcement officers, may properly regard with disfavor.

I would like to stress the fact that the need for a vigorous enforcement program by all of us to combat fraudulent securities sales is more important today than it ever has been. We chuckle sometimes at the historic gullibility of those who were sold gold bricks or the Brooklyn Bridge. But the huge sums of money swindled from our citizens at this moment are extracted on representations equally fantastic. Hardly a year passes that we do not have at least one case in our office of someone who represents that he has a doodlebug which tells him with certainty the precise spot where

oil can be found. These doodlebugs range from a forked stick to complicated machines allegedly powered by atomic energy. Not long ago we convicted a swindler who had extracted large sums from the public for stock in a company which he claimed had perfected a perpetual motion machine. He also had an atomic healing machine which was a panacea for about every disease known to man including cancer. This remarkable machine turned out to be small kitchen cabinet containing a Mazda sun lamp.^{5/}

The old "boiler rooms" which I mentioned are in evidence again. These boiler rooms are maintained by fringe investment outfits and operate in a way that is nothing less than fantastic. The typical boiler room is located in some shabby office building and consists of rows of small cubicles, each one just about large enough to hold one person. Frequently, twenty-five or thirty salesmen are working at the same time. These salesmen are often recruited from ex-convicts, veteran fraud artists, and carnival and circus barkers. Each one has, in his cubicle, a number of telephones, a list of prospective victims, and a three-minute egg-timer. The clatter and din of these pitchmen, frequently stripped to the waist, makes the term "boiler room" an apt description. The egg-timer is used to limit the telephone call unless the prospect shows particular promise. The representations made over these phones are almost unbelievable. The pitchmen work on a production basis. They must make a certain quota of sales proportionate to their phone calls or they are fired. The results are staggering. One boiler room we closed down had, in a few months, grossed commissions -- commissions mind you -- not sales -- of two million dollars.

^{5/} Estep v. United States, 223 F. 2d 19 (C.A. 5, 1955).

The long-distance telephone bill for the same period was \$200,000. A very large proportion of the calls made from these boiler rooms are intentionally made to places far distant from the boiler room and frequently to small communities where the victim ordinarily does not have the facilities for obtaining advice from reputable sources.

We take it for granted, of course, that the large preponderance of the victims of these boiler rooms are uninformed individuals with little or no experience in financial matters. But what is a constant source of amazement to me is the number of persons deceived by these representations who are individuals that should know better. Several months ago the Commission found it necessary to suspend a particular stock from trading on an exchange. We received a call at the Commission from a man who was an investment counsellor in a western city who expressed great concern at the action of the Commission. He had purchased this stock to the extent of \$65,000. When we inquired as to the circumstances of the purchase, he told us that a man he had never heard of, had called him from a brokerage firm in New York City that he had never heard of, and had told him a wonderful story about what a fine investment this was. On the strength of that call he purchased the stock. Of the \$65,000, \$40,000 was teachers' pension funds. You can be of great service to the people of your state if you can impress upon them by every type of publicity at your command to beware of securities which are offered over the telephone by persons or firms with whom they are not familiar.

In conclusion, may I take you back for a moment to the dark days in the early 30's to a time when our people had lost confidence in the capital markets as a place to invest their savings. A few comparative figures may be of interest to you. At that time new issues of corporate securities amounted to about 400 million dollars annually. Today, it averages over 10 billion dollars. At that time the value of all shares listed on the New York Stock Exchange was about 15 billion dollars. Today it is over 200 billion dollars. In my opinion, this restored confidence in our capital markets is due in a large measure to the reliance by public investors on the vigorous enforcement of the securities laws, and that restored confidence, in turn, has contributed to our present prosperity, employment, national income and national productivity.

The importance of maintaining confidence in our securities markets cannot be stressed too strongly. Few of us are unaffected by these markets. The ninety million Americans holding life insurance policies have an indirect interest in these markets through the great investment in the bonds and stocks of corporations held by insurance companies. Beneficiaries under pension funds and holders of investment company shares have a similar interest. And the families of eight and a half million citizens who directly own shares of corporations are vitally concerned. Our corporate wealth is very broadly held. The securities markets provide the mechanism by which business raises the capital required to serve the economic needs of the people. They provide a mechanism by which industry may be broadly

shared by the people. Ownership of American industry has become, through the operation of the capital markets, freely transferable. Investors are willing to place their savings at the disposal of industry, and thus the capital so essential to the nation's economic progress is provided. The preservation of the integrity of these capital markets is our responsibility. It is a very great responsibility and requires the utmost cooperation of all of us working together for the best interests of the American people.